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> **The whole matter may be summed up by saying that a boom is generated when investment exceeds saving and a slump is generated when saving exceeds investment… Whether or not my confidence is justified, I feel no serious doubt or hesitation whatever as to the causes of the world slump. I trace it wholly to the breakdown of investment throughout the world… I suggest to you, therefore, that the question to which we have bent our intelligence are the causes of the collapse of investment and the means of reviving investment.**
>
> **John M. Keynes, *The Originating Causes of World-Unemployment,* 1931**

ON COURSE FOR RECESSION

Assessing the world economy's prospects essentially has to start with an assessment of the U.S. economy's prospects. Clearly, it holds the key position. For years the United States has been the world's main source of demand growth. During the height of the U.S. bubble years — 1995 to mid-2000 — domestic demand growth in the United States averaged 5% per year, as against a mere 2% in the rest of the world.

This soon turned the whole world into a bubble economy that had become excessively dependent on rampant demand creation in the United States, which, conversely, has become excessively dependent on capital inflows.

For some time, two questions about the U.S. economy have been uppermost in our mind. One concerns the corporate profit implosion, both its causes and implications for business investment, and the other one is about the dollar's vulnerability. The possibility, if not probability, that it is heading for an inevitable crash has haunted us for years. It will soon be the whole world's nightmare.

Consider: At end-2001, foreigners held assets in the United States at a market value of more than $9,000 billion and of more than $8,000 billion at current cost. Direct investments and stock holdings accounted for $4,000 billion, or around 45% of the total.

The key factor behind these immense capital flows into the United States from around the world has been blind confidence that America's new paradigm economy, with its superior rates of return on invested capital, would forever be able to attract abundant foreign capital to finance the domestic spending excess, as reflected in the trade deficit's exponential rise.

The whole world wanted to participate in the United States' trumpeted miracles of productivity and profit growth. Daimler Benz snapped up loss-making Chrysler Corp. for $38.6 billion. German Telecom poured $50.7 billion into the purchase of VoiceStream. It took years for those concerned to recognize that the propagated profit miracle was in reality a profit carnage. Horrendous losses are the effective, final result.

Yet anybody who would have bothered for a moment to look at U.S. business profits, as reported in the government's national income accounts, rather than blindly accepting everything that firms and Wall Street analysts were saying, would have easily recognized years ago that the claimed profit miracle was in reality a profit swindle. Profits have been falling since 1998.

It has been some time now since the new paradigm vision of the U.S. economy was shattered. Foreign firms and investors have suffered horrible losses on their American stock investments. The most frightening feature is definitely the inordinate collapse of profits and the associated slump in capital spending.

In the face of this development for which there is no end in sight, a future precipitous slide of the dollar is a

forgone conclusion for us. Yet in comparison to the upheavals that have taken place in the economy and the financial markets, it has remained amazingly resilient. For us, however, that is no reason to believe that this will last.

During the four years from 1997 to 2001, America ran a cumulative trade deficit of $1,300 billion. Comparing with cumulative GDP growth of $1,764 billion, this is an unbelievable spending excess. By definition, such a deficit broadly equals what the nation is spending in excess of domestic output and income growth. Essentially, this required an extremely loose monetary policy.

The chief reason for the dollar's resilience appears obvious. While the U.S. economy and its stock market may be faring poorly, there is a perception that the rest of the world is doing even worse. Europe's economy is proceeding at a snail's pace, with Germany on the brink of recession; Japan remains caught in a stranglehold of bad debts and deflation. Among the major countries, the U.S. economy is the only one that has been showing respectable growth, of 3%.

All this has strengthened the view that the dollar's strength is eternal. As we explain in this letter, we continue to disagree vehemently. What we conjecture behind the dollar's resilience are sustained great illusions about the U.S. economy's health and strength. Its widely hailed respectable growth over the past several years was grossly ill-structured in its pattern and completely unsuited for a sustained recovery.

THERE IS A PRECEDENT

Considering the horrible backdrop of accounting scandals, crashing stock prices, plunging profits, a yawning budget deficit and even an unprecedented negative interest-rate differential against the euro, the dollar has certainly been performing astoundingly well. Yet let's not overlook that against the euro it is down almost 20%.

Inertia of exchange rate expectations is a familiar experience. Basic to the dollar's relative strength is obviously a general perception that the U.S. economy will continue to outperform the economies in Europe and Asia. Somehow in the past few years a perception has taken hold in the currency markets that exchange rates are mainly determined by differences in economic growth. There have, indeed, been striking examples of this kind, but more often it has not been vindicated. All the lessons of history say that in the long run it is the state of the balance of payments that determines the strength of a currency.

Stating this, we have in mind in particular the experience of the 1980s. Then, too, the dollar astounded the world by soaring against the European currencies in flat defiance of an exploding U.S. trade deficit. This was a completely new experience for the currency markets. While the U.S. current account between 1981–85 went from a small surplus of $5,000 billion to a deficit of $121 billion, the dollar skyrocketed against the D-Mark from DM 1.74 to DM 3.42. From then on, though, it was sharply down for the dollar, although the growth of the deficit sharply slowed. The dollar's slump ended in 1995 at DM 1.25.

Now the figures of the recent past for comparison: Since 1997, the rise in the U.S. current-account deficit has grown exponentially from $128 billion to almost $500 billion. But this time, in addition to the mammoth deficit there looms a negative interest rate differential of 2% against the dollar at the short end. During its bull run in the first half of the 1980s, the dollar enjoyed a big interest advantage against the other major currencies.

Currency strength under such extremely negative conditions is definitely unprecedented in history. There is only one possible explanation for this extraordinary experience, and that is phenomenal faith in the U.S. economy's inherent strength and health.

Apparently, it was mainly two influences that drove the dollar's bull run of 1981–85. Probably the most important one was worldwide admiration for America's new "supply-side" Reaganomics, as against pronounced pessimism about the European economies. (Eurosclerosis became the catchword of the time.) A big interest-rate advantage for the dollar was the other influence. The dollar's long decline began in 1985 when, in the face of a weakening economy, the Fed accelerated its interest rate cuts.

It is still widely believed that Reagan's supply-side strategies worked. Nothing could be further from the truth. Looking only at the increases in aggregate real GDP and employment, it was a great success. Economic growth, which had stumbled in the early 1980s, began to surge in 1983, compiling a more durable recovery than

at any time since the 1960s. For more than five years, real GDP kept growing at an annual rate of more than 3%. America's unemployment rate fell from 11% to 6%.

POMPOUS CLAIMS VERSUS POOR REALITY

But looking at the pattern of economic growth and the changes in the allocation of resources, Reaganomics has been a total flop. As we keep stressing, the crux of economic policy is always its impact on capital formation and profits. What happened to the U.S. economy in the 1980s, in actual fact, was the precise opposite of what the supply-siders had expected and predicted. Soaring government and consumer borrowing ravaged capital formation to unprecedented lows, and business profits showed no improvement as a share of national income or GDP.

The net national savings rate — the average rate of business and consumer saving minus the government deficit — virtually collapsed from about 6.5% from 1968–82 to 2% of GDP, due both to sharply higher government and consumer borrowing. Net capital investment as a ratio of GDP fell to 5% of GDP, nearly two percentage points below the postwar average. Manufacturing net investment was flat for years.

Ultimately, "supply-side" Reaganomics grossly failed by all accounts. Three bull years for the dollar were followed by 10 bear years.

We have recalled this experience of the 1980s because of its stunning resemblance in virtually every detail to what has happened in the past few years. It begins with the new era bogus. In the 1980s, it was newly fashioned *supply-side* policies that would do miracles to the economy. In the 1990s, it was a *new paradigm economy* with miraculous efficiency gains through massive investments in the new information technology and a revolutionary improvement in corporate governance, guided by the goal of increasing shareholder value. What's more, in both periods there was exactly the same American derision of Europe's inflexible economies, and on the part of the Europeans there was exactly the same inferiority complex.

Even more stunning are the parallels on the domestic side. In both periods, the pompous claims of superior, new government and corporate strategies contrasted grotesquely with the miserable economic reality. Looking at what effectively happened to the resource allocation between capital formation and consumption and to profits, the policies in both periods were an outright disaster. However, the macroeconomic damages of the 1990s are the worst.

BUT THE FED WAS HIGHLY CRITICAL

Yet there was one striking difference between the two periods. Under Paul Volcker's chairmanship, the Fed's economists were highly critical of the development. Among our files are articles from the *Quarterly Review* of the Federal Reserve in New York with the following titles: "*Evaluating Recent Trends in Capital Formation*" (Autumn 1989), "*The Decline in U.S. Saving and Its Implications for Economic Growth*" (Winter 1991), "*The Supply-Side Consequences of U.S. Fiscal Policy*" (Spring 1992).

These and other articles were unanimously extremely critical about the U.S. economy's macroeconomic development under the impact of the new policies. To quote a few sentences from the conclusions of the "The Decline in U.S. Saving and Its Implications for Economic Growth" article mentioned above:

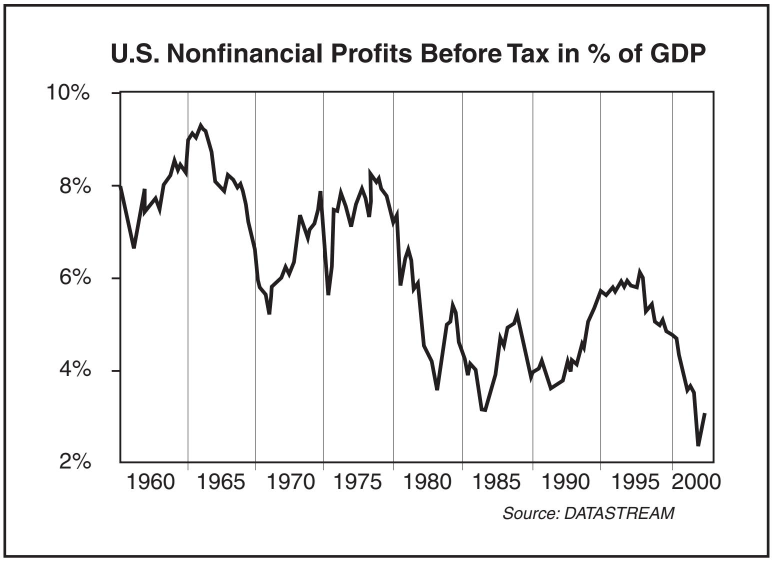
> *The 1980's saw net national saving fall to its lowest rate of the postwar period. All measures of saving that estimate the actual acquisition of productive assets confirm this finding. The costs of this poor performance have been subtle but quite real: temporarily higher consumption has been gained at the long-run expense of several years of GNP growth and a complete reversal of the U.S. external debt position.*
>
> *Traditional model estimates indicate that the drop in saving in the 1980s has already cost the U.S. economy about 15% of the capital stock, lowering potential output by 5%…*

During the 1980s we were among the minority of highly critical observers of the economic development in the United States. Observing the resulting, highly negative trends in domestic saving, net investment and profits, we were appalled. But observing their development in the late 1990s, we are far more appalled.

The imbalances and structural distortions that accumulated in the U.S. economy and its financial system during the past boom years are of unprecedented scale and have made both of them more vulnerable than ever before.

A PROFIT CARNAGE OF FIFTY YEARS

Long experience says that healthy economies have healthy profits. This has its plain, decisive cause in the fact that healthy economies typically have a high rate of capital spending that, by correspondingly increasing business revenues, tends to be the main source of profits.



Over the past few years, we have persistently emphasized that the alleged new paradigm U.S. profit miracle was a mirage. Pondering its causes and implications, we decided to take a look at the development during the whole postwar period, measuring profits as a share of GDP. Profits tend to rise all the time, but what matters is their rate of growth in relation to the economy's rate of growth. The chart to the left is the result. Frankly speaking, it surprised and shocked us. What it really reveals is a progressive, dramatic profit deterioration over the whole postwar period.

According to the chart, the decisive, big break occurred in the period from the late 1970s to the mid-1980s. The obvious main depressants were the temporarily sky-high interest rates and weak economic growth. But what strikes us most is the extraordinary weakness of the profit recovery during the economy's rebound in the 1980s. A sharper increase had to wait until the first half of the 1990s, which was a period of slow growth and low interest rates. Between 1997–2000, while the economy boomed, these gains were undone again with a slump, as a percentage of GDP, from 6% to 3%.

The recent slide strikingly resembles the steep slide after the last 1970s. But there is a diametric difference between the two periods. Then, it was a time of record-high U.S. interest rates. This time, the profit collapse has happened despite record-low interest rates.

This is probably the most shocking but also most instructive chart about the U.S. economy's performance during the whole postwar period. It pinpoints its key problem, and that is chronic, poor profitability, and considering its protracted, accelerating downtrend, it appears manifest that it is a deep-seated, structural phenomenon.

Profits have hit a rock-bottom postwar level, even though the recession of 2001 has been hailed as the shallowest in the whole period. We would say that this is a frightening coincidence. What is going to happen to profits when the economy slides back into a deeper and more prolonged recession, of which, according to the latest economic data, there can be no doubt of anymore?

AN ILL-STRUCTURED RECOVERY

Measured by aggregate, real GDP, the U.S. economy has done respectively well since its 2001 recession, far better than any other major country. In the third quarter of 2002, it was up 3% over the year and 4%, at annual rate, over the prior quarter. For many, this performance is further compelling proof of the U.S. economy's superior dynamism and flexibility that will also prevent any serious recession in the future.

Taking a closer look at what happened to the composition of GDP during the recovery, we have a diametrically different opinion. To begin with, while the economy's growth rate of 3% may compare favorably with those of other countries, it compares miserably with the growth rates of past cyclical recoveries, having

averaged more than 5%. But our main concern about the U.S. economic recovery derives from its grossly ill-structured pattern.

PATTERN OF PAST POSTWAR U.S. ECONOMIC RECOVERIES
(PERCENTAGE CHANGES IN VOLUME, ANNUAL RATES)

	2001 QIII to 2002 QIII	Average of Past Recoveries
Real GDP	3.0	5.3
Personal consumption	3.7	5.1
Nonresidential structures	-19.7	2.4
Producers durable equipment	1.0	9.4
Residential construction	1.0	13.2
Net exports	-17.2	-0.1
Government spending	4.7	1.2
Private employment	-0.1	3.3

Source: Survey of Current Business

Most important, though, is the diametric difference between the pattern of past recoveries and that of the recent one. As the above figures show, the U.S. economy's past recoveries from recession have consistently been propelled by a surge in capital spending, mainly housing and business equipment. Consumer spending as a whole used to lag GDP growth by a small margin.

Clearly, there is no resemblance with the pattern of past recoveries. First of all, consumer spending has been its one and only propellant, but at a much more moderate pace than in past recessions; second, the recent recovery has been exposed to two unprecedented major drags: a virtual collapse of non-residential construction and a soaring trade deficit; and third, business spending on equipment has remained extremely weak.

As to the figures for business equipment, we have to add that, as usual, computer investment is again heavily bloated by hedonic pricing, reflecting increases in computer power. In actual dollars, business spending on computers over the year increased by just $9.8 billion, from $67.6 billion to $77.4 billion. But measured in hedonic dollars that enter real GDP, this spending soared from $224.5 billion to $299.9 billion, or $75.4 billion. The difference between the two measures, by the way, accounted for almost one-fourth of the real GDP growth, and accordingly, of course, equally to productivity growth.

Exceptionally big contributions to the U.S. economy's recovery came furthermore from government spending and diminished inventory liquidation, contributing together almost 60% to the recorded real GDP growth. The single biggest component was consumer spending, accounting for 86% of the recorded real GDP growth. But as reflected in the soaring trade deficit, almost one-third of that spending effectively failed to increase GDP because it vanished in the booming imports. Growth of real final sales in domestic product averaged 1.5% during the recovery, as against an average of more than 4% in past recoveries.

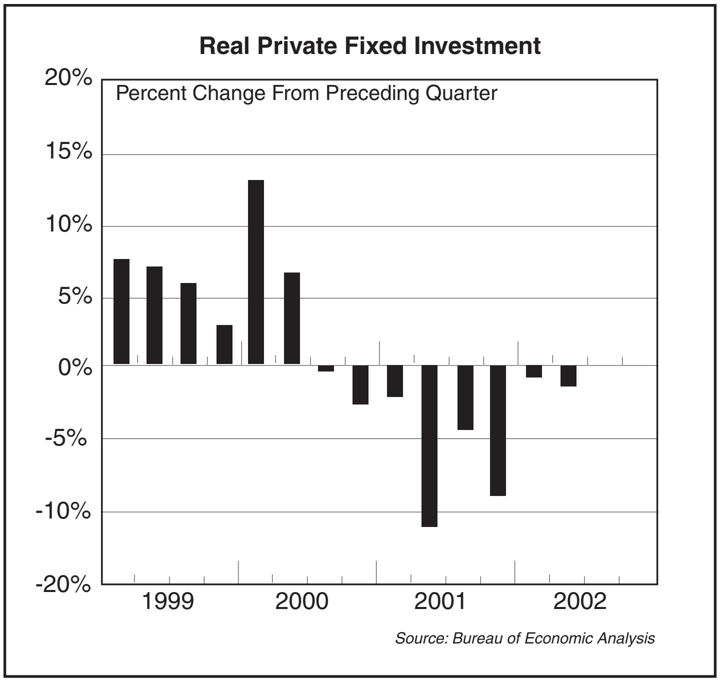
Putting it briefly and bluntly: The U.S. economy's recent recovery lacks everything that could possibly make for a sustained recovery. Not only is the long-awaited, necessary turn in capital spending still on hold but it actually keeps declining, soon to be joined by housing, actually showing anemic growth. The boom is only in prices.

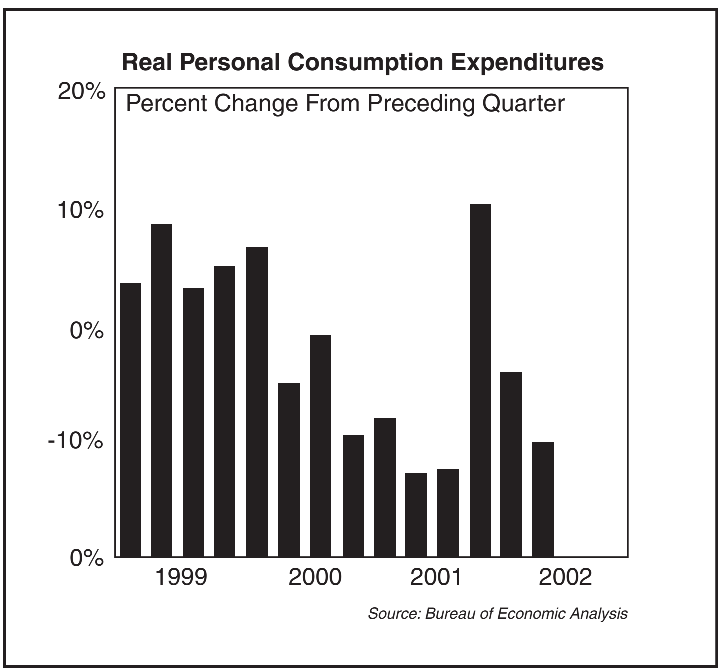
UNITED STATES — ON THE BRINK OF RECESSION

For us, the U.S. economy's recovery is already a thing of the past. The most important question now is what follows in the fourth quarter and thereafter. The latest data make uniformly dismal reading. But attention remains concentrated on positive interpretations. When the Commerce Department recently reported that retail sales had been flat in October, it was generally stressed that ex plunging auto sales, there was an unexpected

rise. Of course, it is the total that counts for GDP growth.

In actual fact, consumer spending began the fourth quarter in a deep hole. In total, it had risen 0.9% in July; its growth faded to 0.2% in August, and declined 0.6% in September. That is, the reported flat October sales followed extremely weak September sales. A crash in car sales had accounted for much of the slowdown, but spending has broadly tailed off. If November–December sales fail to surprise strongly on the positive side, consumer spending will provide minimal or no lift at all to fourth-quarter growth.





Observing, on the other hand, nil improvement, if not further deterioration, in the capital spending sphere, it seems to us a compelling conclusion that America, too, is effectively on the brink of recession. But we read that only about other countries, in particular Germany and Japan. Frankly speaking, the economic reporting in the media is very lopsided in favor of America.

It appears to us that these data, covering several months, conclusively suggest that the American consumer has started to retrench. Nobody, though, wants to believe it simply because there is nothing else in sight to prop up the economy.

An often-heard argument is that the consumer's income growth has so far kept up rather well. Quite a bit of it was due to the government's tax cuts. Another main source is, of course, his own spending. Any retrenchment in spending essentially implies an equal income loss for the economy as a whole.

Nevertheless, growth of the consumer's disposable income has fallen to about $200 billion at annual rate. On the other hand, the consumer has plainly decided to rebuild his savings, running lately at an annual rate of 3–4% of disposable income. Considering possible and even probable increases in personal saving, stagnating consumer spending is easily feasible.

Recessions implicitly reflect the fact that businesses and consumers redress the spending and borrowing excesses that they have incurred during the boom. A return to sustained, normal economic growth cogently requires the ending of the distortions of the boom. The adjustment process consists of the economy's return to the desired consumption/saving pattern. Essentially, the painfulness of this adjustment process is determined by the scale and the nature of those distortions.

Mr. Greenspan likes to explain the U.S. economy's resilience with its extraordinary flexibility, suggesting that the necessary adjustments were speedily undertaken. That's certainly what he wants to believe. But the truth is that this resilience has its obvious reason in the fact that the consumer has plainly refused any retrenchment.

With the generous help of Mr. Greenspan, he prolongs and extends his spending excesses. That is the exact opposite of adjustment and flexibility.

OVERCONSUMPTION OR OVERINVESTMENT?

What exactly are the unsustainable main distortions in the U.S. economy? With utter amazement, we keep reading that Corporate America had overinvested in plant and machinery during the past boom years. The proof is widely seen in the fact that fixed investment has virtually doubled its share of GDP growth from one-sixth to one-third. In this view, the ongoing investment slump is correcting the former investment excess, qualifying thus as a positive and desirable adjustment process, reflecting the shedding of excess capacity.

Again, we vehemently disagree with this interpretation of the U.S. investment slump. Our main objections are of two kinds: *first*, the measured capital investment ratios are grossly distorted to the upside; and *second*, there has manifestly been massive malinvestment in high tech, retail trade and finance, at the expense of manufacturing.

As to the first point concerning the flawed measurement of capital investment, we have to come back to two distortions that we have written about many times. Hedonic pricing of computers is the one, and a pronounced shift towards very short-lived investment, implying sharply rising depreciations, is the other. Net investment, which alone adds to productive capacity, is near postwar lows.

Hedonic pricing, to repeat, measures business spending on computers not by the amounts of money actually spent, but by the rise in computer power. Between 1997–2001, business spending on computers in dollars has declined from $79.6 billion to $74.2 billion, after an interim peak of $93.3 billion in 2000. But measured in hedonic dollars, that spending shows a steep increase from $102.9 billion to $239.9 billion, and these are the numbers that enter real GDP. We have always argued that the hedonic pricing makes no economic sense because it creates immense amounts of dollars that nobody has spent and nobody received.

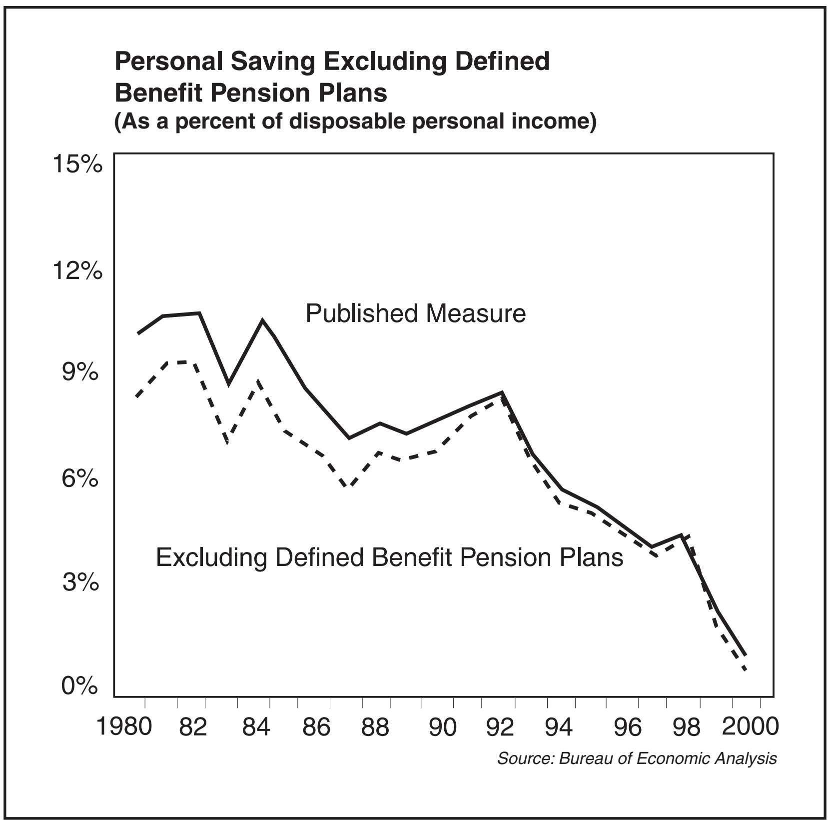
The other major factor behind the upward distortion of the numbers for capital-investment is a pronounced change in its whole investment pattern from traditional equipment towards very short-lived investment in new high-tech equipment, particularly computers. This shift has substantially increased the fraction of capital investment that depreciates every year.

That is, an increasing chunk of the rise in capital spending is simply replacing capital that wears out. Only investment above the amount lost to depreciation, or net investment, adds to the available capital stock, and according to official figures that is close to its postwar low in the 1980s.

SAVING IS THE KEY MEASURE

But our strong discord with the widespread view that America's past boom was investment-led has still another absolutely compelling reason. And that relates to the collapse of national saving.

In order to make capital investment possible, it is necessary that the consumer allocate a part of his current income to saving. By doing so, he releases a corresponding share of productive



resources that the business sector can use for the production of capital goods. It's highly important to realize that, in the aggregate, higher capital investment can come from no other source. Savings sets the limit for capital investment.

Now, what happened to personal saving in America during the past 10, 20 years? In the first half of the 1980s, the consumer saved about 10% of his disposable income. That fell successively in the second half to 7.5% in 1989. During the first half of the 1990s, it edged further downward to 6.1% of disposable income, to be followed in the second half by a steep decline, hitting almost zero in late 2001.

It ought to have been crystal-clear to everybody with a little knowledge of macroeconomics what this savings collapse implied for the resource allocation in the U.S. economy. It said that consumption was taking a sharply rising share of available resources. Between 1997–2001, it absorbed 90% of GDP growth, measured in chained dollars, and 82.6 %, measured in current dollars. This compares with a consumption share in GDP of 67% during the 1980s, and of about 63% during the earlier decades. Even for America, this was a consumption boom of unprecedented vehemence.

We have always been amazed that nobody seemed to care about this developing, unsustainable drastic distortion in America's demand structure, essentially fostering a corresponding, drastic distortion in its output structure. Instead, even economists of the Federal Reserve discarded the savings collapse as an event without importance, arguing that the soaring wealth in the stock market was a valid substitute. This may appear so to the stock owners. But this complacent view, of course, ignores the decisive negative macroeconomics effect in resource allocation.

Like their bosses, they are unable or unwilling to see any serious problem in the U.S. economy. The highly adverse implications inherent to the savings collapse for the economy's use and allocation of productive resources has never been mentioned and is apparently not even considered.

A WEB OF FALLACIES ABOUT CONSUMPTION AND INVESTMENT

Mr. Greenspan has been criticized for his failure to do anything against the developing bubble. His answer is that it is very difficult, if not impossible, to identify a bubble before it bursts. We are not aware of any protest against this unbelievably simplistic response from the world's leading central bankers.

In the introduction of the August letter, we quoted John M. Keynes on this question. In essence, he said, a central bank should have no concern with the level of stock valuations, but it ought to have an indirect concern when rising stock values disturb the equilibrium between investment and saving. In other words, he said, the decisive question is whether the changes in asset prices impact the demand side of the economy, either by boosting investment or by boosting consumption. The latter is most easily recognizable in falling savings.

With this remark, Mr. Keynes really hit the key point. A central bank may disregard rising stock prices, but when it notices that they substantially impact the level and pattern of spending in the economy, it must consider responding. In the U.S. case, the decline of saving after 1997 was so dramatic and so spectacular that it ought to have alerted Mr. Greenspan and American policymakers in general. It is the distinguishing feature of a bubble economy that rising asset prices fuel higher spending.

One reason for this general unconcern in America about this savings collapse seems to be a widespread assumption that higher investment depends primarily on rising consumer demand. The famous Keynesian Acceleration Principle says that growing consumer demands exerts a multiple leverage effect on investment, magnifying and accelerating it.

The seemingly plausible acceleration principle is, first of all, not from Keynes himself, but an invention of American Keynesians; and second, it is a web of fallacies. In a fully employed, booming economy, as in the United States in the late 1990s, investment can only increase when consumption decreases, and conversely, higher consumption is only possible through lower savings and investments. The latter is precisely what happened. Soaring consumer spending crowded out savings and investment.

LOW AND ILL-STRUCTURED INVESTMENT

Recessions, to repeat, are the phases in the business cycle in which consumers and businesses redress their spending excesses, returning to normal, desired investment and savings ratios.

Trying to assess the progress of this adjustment process essentially has to start with an examination of what needs to be adjusted.

In the consensus view, America's current recession has been caused largely by an investment boom that has turned to bust because ferocious competition and ample global capacity are holding down prices, badly squeezing profits.

According to Mr. Greenspan, the boom-related imbalances in the U.S. economy are being *"addressed more expeditiously and effectively than in the past, aided importantly by the more widespread availability and more intensive use of real-time information."* For sure, this is a comforting explanation for the capital spending slump. No less important, of course, is that Corporate America is solving its dismal profit problem. In this respect, people and markets are drawing comfort and confidence from reports of general, strenuous efforts to cut costs.

We regard this positive assessment of the U.S. economic situation and of the positive corporate response as grossly flawed. True, slumping business investment has primarily driven the downturn, yet this is by no means the bust of a prior investment boom. There never was such a boom. Proper measurement, focusing on net investment, shows mediocre capital formation for the past several years at best. Net investment, and only net investment, effectively adds to the capital stock, incomes and profits, and that is close to historical lows.

Net investment essentially represents the saved part of GDP. During the second half of the 1990s, it accounted for 3–4% of total GDP, but for less than 1% of current GDP growth. Its postwar record-lows occurred in the second half of the 1980s with a GDP ratio of less than 3%. It had its highest ratios during the postwar period in the 1960s at 6–7% of GDP. In 2001, its share of GDP was down to 2.6%, exerting a strong negative effect on GDP growth.

What the U.S. economy truly experienced in the past few years was the wildest and most reckless consumption boom ever in history, associated with collapsing saving and an extremely low level of net investment. But we think that low net investment is only part of the problem. Another part is a grossly unbalanced investment structure. Protracted, gross underinvestment in manufacturing has contrasted with protracted, heavy overinvestment in the new information technology, retail trade and finance.

Measured in current dollars, 39% of the increase in business investment went into the new high-tech equipment, while only 8.9% went into industrial equipment. Measured in chained dollars, it was 80% versus 5.6%. Comparing these figures, keep in mind that high tech accounts for only 5–6% of total industrial production.

Now back to the all-important question whether and to what extent the boom-related imbalances and excesses in the U.S. economy are being addressed. Earlier we quoted Mr. Greenspan, stating that they are *"more expeditiously and effectively addressed than in the past."* The truth, rather, is that post-bubble adjustment has not even started. The ill-structured pattern of the bubble years has continued. Consumption accounted for 86% of the recovery from QIII 2001 to QIII 2002, while nonresidential investment continued to slump. And the monstrous U.S. trade deficit has not adjusted.

But aren't corporations drastically adjusting by getting rid of excess capacity though slashing new investment? The first fallacy in this widespread view, in our opinion, is that the investment boom is a mirage. There was one in high tech, but nowhere else. Overall, manufacturing net investment has been flat, at best. If substantial unused capacities truly existed across the board, this ought to slow imports.

But why, then, the investment slump? It reflects America's main structural problem, and that is excessive consumer demand, absorbing 80–90% of GDP. It may seem paradoxical that slumping investment is caused not by insufficient but by excessive consumption demand. Implicitly, this leaves correspondingly less room for capital formation. Friedrich Hayek called this pattern the *"the central point of the true explanation of crises: excessive demand for consumer goods leads to unemployment in the capital goods industries."*

In reality, it is not a paradox at all. It is a clear crowding-out case. In the 1980s, government borrowing and spending crowded out saving and investment. In the last several years, it has instead been a solitary consumer borrowing and spending spree, strikingly reflected in the exponential rise of the U.S. current-account deficit.

NO HOPE FOR PROFITS

What, then, has been and continues to be the main depressant of capital spending in the United States? A lack of consumer demand was definitely not among the causes. The crucial factor, without the slightest doubt, is and remains the extraordinary profit carnage. But what has been and continues to be responsible for that? This, really, is the one question about the U.S. economy that ranks above all others.

As to profit prospects, we only read highly optimistic forecasts suggesting substantial improvement in the fourth quarter and familiar double-digit growth for next year. The underlying optimistic, main assumption seems to be that the U.S. economy has no serious problem that could jeopardize its recovery much longer.

To quote Stephen Roach of Morgan Stanley: *"Investors are utterly convinced that policy can fix anything that ails America — from deflation and asset bubbles to asset-liability mismatches and geopolitical threats. Denial has yet to crack."* There are no debt problems, no structural problems, and the monstrous current-account deficit is the innocent counterpart of foreigners wishing to invest in the United States. Definitely, very few seem to grasp the enormity of the damage that has been done to America's economic and financial structures in the past few years.

As to profits, the general, hopeful expectation and explanation is that corporations will use their knives to cut costs more rigorously than ever. In *Alice in Wonderland* fashion, they talk of rising profits and recovery and ignore the contraction all around them.

In past letters, we have stressed again and again that higher profits and higher prosperity cannot possibly come out of general cost cutting. Sorry that we have to repeat ourselves, but this is the most dangerous fallacy in American thinking about profit creation. It is micro-logic erroneously applied to a macroeconomic problem. While cost cutting can lift the profits of single companies, it becomes self-defeating when widely practiced, squeezing profits overall.

In fact, this has been happening in the United States at a rapidly escalating scale in the name of maximizing shareholder value. Being aware of the close link between corporate expenses and revenues, we have been highly critical right from the beginning of the corporate strategies that the new equity culture finds fashionable.

Manifestly, they intensified an existing bias towards a short-term horizon, and in the same vein a bias toward asset shuffling instead of asset creation. Mergers and acquisitions, downsizing, restructuring, cost cutting, all these catchwords of the new equity culture gave the impression of highly sophisticated corporate strategies, but in essence they were all synonymous with lesser organic growth through new investment. Effectively, this could only minimize, rather than maximize, profits.

IT'S STRUCTURAL

It may appear paradoxical, but excessive cost cutting and asset shuffling versus too little net investment are the root causes of corporate America's poor profitability. The problem is so unbelievably simple, and yet so unbelievably little understood. Profits are the difference between overall business revenues and business expenses.

The key mistake in the widely prevailing perception about profit creation is the assumption that business revenues are governed by consumer spending. They are in reality governed by business spending. It effectively represents the single biggest and therefore decisive source of business revenues. Consider that consumer incomes result ultimately from business expenses. Therefore each dollar cut from business expenses is a dollar cut from business revenues.

The chart on page 4 illustrates that the U.S. economy's poor profit performance really started in the early 1980s. After a modest recovery in the first half of the 1990s, it fully collapsed in 2000–2002. We looked for

reasons and found four altogether. They are: *first*, soaring corporate interest rate expenses; *second*, accelerating capital consumption charges; *third*, the exploding trade deficit; and *fourth*, record-low net business investment.

It is well known that in the past several years Corporate America has stampeded into debt. But there are two very important points to see about this stampede. First of all, it was heavily concentrated in manufacturing; and second, it was not for the purpose of building factories but for mergers, acquisitions and stock buybacks.

As a consequence, interest expenses of manufacturing skyrocketed between 1997–2001 from $44.9 billion to $81.4 billion, that is, by 81%. But there is another big negative to be taken into account, and that's the simultaneous ravage that occurred on the asset side of corporate balance sheets. The single biggest investment was "goodwill" reflecting the grossly excessive prices paid for mergers and acquisitions. In other words, the particular problem with the surge in indebtedness is that it overwhelmingly financed such worthless "goodwill."

As to the profit squeeze by accelerating depreciation charges, they increased by 33% over those years, as against an increase in total nonresidential investment by 20%. Net investments in 2001 were below their level in 1997. As earlier explained, this has its reason in a shift in the investment pattern towards short-lived assets.

Our calculations, nevertheless, come to the result that Corporate America's single biggest profit killer has been the exploding trade deficit. As we have also repeatedly explained, this has its reason in the fact that the money buying the surging import flow comes overwhelmingly from Corporate America's wage bill. It is wage expenses that emigrate to foreign producers. We took a look at the development of the relationship between nonfinancial profits and the trade deficit since the early 1980s.

	NONFINANCIAL PROFITS	CURRENT-ACCOUNT DEFICIT
	(in $ billions)	
1981	159.6	+ 5.0
1983	153.3	-44.0
1985	172.3	-124.2
1987	193.3	-167.4
1989	219.3	-105.6
1991	226.5	- 9.5
1997	504.5	-128.3
1998	478.8	-203.8
1999	455.9	-292.8
2000	423.0	-410.3
2001	333.7	-393.4

Source: Survey of Current Business

Consider the dramatic deterioration in the relationship between profits and the trade deficit. Lately, the deficit exceeds total profits. For the reasons expounded, there is a direct causal relationship: American producers have the wage costs, foreign producers have the revenues and the profits from this large source of spending.

The fourth structural profit killer in the U.S. economy, after all, is the anemic rate of net investment. Net nonresidential investment in 1997 amounted to $299.7 billion. After peaking in 2000 at $407.3 billion, it fell to $268.1 billion in 2001. Its increase, as already mentioned, accounted for less than 1% of GDP growth.

Apparently, there exists little or no understanding at all of the fact that, from a macro perspective, net investment is normally the economy's most important single profit source. It adds to business revenues without generating an immediate expense. No expenses are incurred until the first, gradual depreciation charges set in.

We identified four different, major drags on U.S. corporate profits. They are definitely not cyclical in character. Beyond any doubt, they are structural. Their origin is not simply in the business cycle. All of them are rooted in the particular strategies that Corporate America has developed during the past several years in its reckless pursuit of quick profit maximization. In reality, it was maximization of macroeconomic follies.

CONCLUSIONS:

America produces an unexampled plethora of economic statistics. The underlying idea is certainly that the most complete and most detailed information is helpful and important in assessing economic developments. European economists used to have very little esteem for this American speciality. Hayek, the Austrian, emphasized that the value and success of statistical research depend primarily upon the guidance from a sound theoretical conception.

To us the whole discussion about the U.S. economy and the world economy is sheer indiscriminate number crunching that makes no distinction between data and questions.

In any case, there prevails a preconceived idea that the U.S. economy has excellent fundamentals and has therefore no serious problems. The savings collapse, the profit carnage, the investment slump, all these massive structural distortions and dislocations in the economy's structure find little or nil attention in the discussion. The monstrous current-account deficit, approaching an annual rate of a $500 billion, is the innocent counterpart of foreigners eager to invest in the United States.

A lot of energy has been devoted to whether there will be a double-dip into recession. This is the wrong question. What matters instead is whether capital spending will rebound after its steepest decline in the whole postwar period. This is also a question that can be answered with reasonable certainty from the available data.

If yes, the U.S. economy has a chance for a sustained recovery. If not, it will see Japanese-style near-stagnation and sub-par growth for years to come. We think the prevailing conditions speak overwhelmingly for the latter.

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